COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

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In the Matter of:

NOTICE OF CONTINENTAL TELEPHONE COMPANY OF KENTUCKY OF AN ADJUSTMENT IN ITS RATES	)))	CASE NO. 9230

O R D E R

On December 28, 1984, Continental Telephone Company of Kentucky ("Continental") filed notice with the Commission proposing to increase its intrastate telephone rates for service rendered effective January 17, 1985. The proposed rates would increase Continental's intrastate revenue by $3,881,040 annually, an overall increase of approximately 15 percent. In this case, Continental proposed to apply the entire request to its local service for an increase in local service revenues of approximately 33 percent.

On January 9, 1985, the Commission suspended the proposed rates until June 17, 1985, to conduct public hearings and investigate the reasonableness of the proposal. A hearing was held on May 1, 1985, with the Consumer Protection Division of the Attorney General's Office ("AG") and AT&T Communications of the South Central States, Inc., being the only intervenors. Briefs were filed by May 22, 1985, by the AG and Continental.

This Order addresses the Commission's findings and determinations on issues presented and disclosed in the hearings and investigation of Continental's revenue requirements and rate design and provides rates and charges that will produce an increase in annual revenues of $219,184.

COMPANY BACKGROUND

Continental is a wholly-owned subsidiary of Continental's Telecom, Inc. ("Telecom") (formerly Continental Telephone Corporation). Continental operates in all or parts of 21 counties in the Commonwealth of Kentucky, having its principal office in London, Kentucky. Continental served approximately 57,514 customer access lines as of October 31, 1984.

ANALYSIS AND DETERMINATIONS

TEST PERIOD

Continental proposed and the Commission has accepted the 12-month period ending October 31, 1984, as the test period in this matter.

VALUATION METHODS

Net Investment

Continental proposed a Kentucky intrastate net investment rate base of $61,359,187[1] at October 31, 1984. The Commission has accepted the proposed rate base with the following exceptions: Continental proposed an adjustment to its depreciation expense to reflect end-of-period plant in service and the change in depreciation methodology previously allowed by the Commission in Case No. 8428,[2] but failed to make a corresponding adjustment to

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1 Smail Prefiled Testimony, Schedule 2, Item 1.

2 Notice of Continental Telephone Company of Kentucky of an Adjustment of its Intrastate Rates, dated June 18, 1982.

its reserve for depreciation. Since the proposed adjustment to depreciation expense is to reflect the level of expense that would have been incurred during the test period had those rates been in effect, the Commission is of the opinion that it is appropriate to account for the effect that the proposed depreciation expense would have on the accumulated reserve for depreciation had the proposed expense been the actual level of depreciation expense incurred during the test period. Thus, the Commission has increased Continental's reserve for depreciation by $176,436[3] to reflect additional depreciation expense allowed herein.

Continental further proposed to reduce its test period net investment rate base by $53,127 to include the projected effects from the loss of terminal equipment.[4] In addition Continental proposed to increase its rate base by $933,841 to reflect an incremental increase per access line.[5] The Commission has rejected these proposals which are discussed in further detail in other sections of this Order.

Pursuant to a data request dated February 5, 1985, Continental revised its adjustment for detariffing of mobile telephone equipment for total company by $5,714 to reflect the investment tax credit in conformance with Administrative Case No.

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3 $215,798 x .8176 = $176,436.

4 Small Prefiled Testimony, Schedule 2, Item 1.

5 Ibid.

269.[6] The Commission has determined this adjustment to be $4,681 for intrastate purposes based on the ratio of intrastate operations to total operations.

Therefore, the Commission has determined the appropriate Kentucky intrastate net investment rate base at October 31, 1984, to be $60,306,718, calculated as follows:

Telephone Plant in Service		$ 93,294,691
Plant Under Construction		4,520,616
Less:	Depreciation Reserve	26,575,390
	Net Telephone Plant	$ 71,239,917
Add:	Materials and Supplies	256,577
Less:	Deferred Income Taxes:	
	Accelerated Depreciation	10,483,060
	Pre-1971 Investment Tax Credit	25,959
	Affiliated Purchases	597,887
	Plant Allocated to Direct Sales	61,689
	Mobile Telephone Investment	21,181
Net Investment Rate Base		$60,306,718

Capital

Continental proposed an adjusted end-of-test year total company capital of $66,126,796.[7] Based on the ratio of intrastate net investment to combined net investment of .8192,[8] the Commission has determined that Continental's capital applicable to intrastate operations is $54,171,071. This amount has been

6 The Sale and Detariffing of Embedded Customer Premises Equipment, dated January 30, 1985.

7 Smail Prefiled Testimony, Schedule 4, Item 2, page 1.

8 Intrastate rate base of $60,307,732 ÷ equivalent total company rate base of $73,615,198 = .8192.

increased by $5,786,121[9] to include the intrastate balance of Unamortized Investment Tax Credits - Revenue Act of 1971 ("JDIC"). JDIC has been allocated to each component of the capital on the basis of the ratio of each component to the capital excluding JDIC. The Commission is of the opinion that this treatment is entirely consistent with the requirement of the Internal Revenue Service ("IRS") that JDIC receive the same overall return allocated to common equity, debt and preferred stock.

Furthermore, the Commission has reduced capital by the amount of intrastate net investment allocated to the unregulated direct sales program and its detariffed mobile telephone investment of $61,689 and $21,181,[10] respectively. These reductions have been made in order to reflect only capital supporting utility operations and they have been assigned to the capital components based on the accepted capital structure herein.

Therefore, the Commission has determined the level of capital devoted to intrastate utility operations to be $59,874,322 as follows:

	Intrastate	Structure
Common Equity	$26,075,250	43.55%
Preferred Stock	1,149,886	1.92%
Long-Term Debt	32,649,186	54.53%
TOTAL	$59,874,322	100.00%

9 Response to Staff Data Request dated December 20, 1984, Item 11b, as Revised February 28, 1985.

10 $25,855 x .8192 = $21,181.

REVENUES AND EXPENSES

For the 12 months ending October 31, 1984, Continental had total company net operating income of $7,457,057.[11] In order to reflect current operating conditions, Continental proposed several adjustments to revenues and expenses that resulted in an adjusted test period total company net operating income available for return of $6,804,091, or $5,327,030 on an intrastate basis.[12] The Commission has determined the appropriate level of adjusted test period net operating income available for return from intrastate operations to be $6,492,880.

In its analysis of Continental's operations, the Commission has accepted the majority of the pro forma adjustments. In the following sections the Commission will outline the adjustments which it did not accept and other adjustments made to Continental's intrastate net operating income:

Wages and Wage-Related Expenses

Continental proposed to increase its wages to reflect a 6 percent increase to its management employees in December 1984 and an anticipated 6 percent increase to its non-management employees in February 1985. Continental further proposed an increase of 5 percent for all its employees in December 1985 and February 1986. The exhibits Continental submitted reflected the reduction in wages and wage-related expenses from a reduction in its work force during the test period. Subsequent to the May 1, 1985, hearing,

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11 Smail Prefiled Testimony, Schedule 3, Item 1.

12 *Ibid.*

Continental submitted revised exhibits, reflecting the actual 5 percent wage increase granted craft employees in February 1985.

Continental conceded at the May 1, 1985,[13] hearing that other companies are cutting back on wage increases and that South Central Bell Telephone Company ("Bell") was awarded 3.8 percent for nonmanagement and 4.9 percent for management employees. The Commission has noted with considerable interest the dramatic deceleration in wage and benefit growth among industries such as trucking, airlines, and busing that has been subject to substantial deregulation. Within these industries there are many examples of actual wage and benefit reductions. A similar pattern has been evident throughout the economy in industries that have experienced intense competition. Given present economic trends, it is essential that compensation policies for utility employees reflect their counterparts in competitive industries. The Commission finds 5 percent increases would adequately reflect these conditions for management as well as nonmanagement employees. This results in a reduction in total wage expenses of $42,831 on a combined basis.

From responses to information requests and testimony at the hearing, it was determined that the December 1985 and February 1986 wage adjustments were based on projections. Continental further stated at the May 1, 1985, hearing that estimations were

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13 Transcript of Evidence ("T.E."), May 1, 1985, page 66.

used to predict the future levels and that they were unaware of what the exact level of employees would be at that time.[14] Therefore, the Commission is of the opinion that this portion of the wage adjustment is neither known nor measurable and such projections could lead to an inappropriate matching of revenues and expenses. It is noted that these wage adjustments would not be implemented until some 13-15 months beyond the end of the test period. The Commission's findings are readily supported by Continental's own inaccurate estimation of 6 percent for the February 1985 craft wage increase which was ultimately revised to utilize the actual 5 percent increase. This further reduces combined expenses by $70,442.

Thus, the Commission has reduced Continental's total wage expenses by $113,273 on a combined basis or $91,913 on an intrastate basis. Other corresponding and minor adjustments have also been made to reflect decreased wage expenses charged to construction and decreased payroll taxes in the amounts of $38,364 and $3,576, respectively. The sum of these adjustments increases Continental's intrastate operating income by $28,997.[15]

Customer Premises Equipment ("CPE") Erosion Adjustment

Continental proposed to decrease its normalized test period local service revenue by $513,743 to reflect the future erosion of lease revenue from embedded CPE as a result of the deregulation of new CPE and consequent competition in the CPE market. The amount

14 Ibid., page 68.

15 $91,913 - $38,364 + $3,576 = $57,125 X .5076 = $28,997.

of the adjustment was based on a 22-month period ending October 31, 1984. The average percentage monthly reduction in revenue thus determined was projected forward to the mid-point of the first year that new rates would be applicable.[16] In addition, Continental proposed cost savings as a result of this erosion of CPE totalling $81,798 on a combined basis and a reduction to its combined rate base of $64,851.

In Case No. 9011,[17] Continental made a similar adjustment to reduce its local service revenue. In that Order, the Commission rejected Continental's erosion adjustment and listed some five reasons as to why the adjustment was not valid. In this proceeding, Continental has presented no additional evidence other than to identify changes to the rate base and cost savings.

Each of the reasons presented in the prior case is still valid. In particular the proposed linear projection which will ultimately diminish Continental's CPE investment and revenues to zero is unrealistic. In its Brief, Continental stated that it should be conceded that its projection was statistically reliable.[18] However, in the same Brief, the actual revenue decline through April 1985 covering a 6-month period was stated to be only $14,800,[19] far short of the projected decline of $513,743

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16 Smail Prefiled Testimony, page 42.

17 Notice of Continental Telephone Company of Kentucky of an Adjustment in Its Rates, dated October 5, 1984.

18 Continental's Brief, May 22, 1985, page 3.

19 Ibid., page 4.

for a full year[20] and certainly not indicative of a simple linear equation.

Therefore, the Commission has increased Continental's net intrastate operating income by $226,698.[21] Concurrently, the proposed rate base reduction was disallowed in the applicable section of this Order.

Attrition

Continental proposed to increase its combined rate base by $1,139,927, decrease local service revenue by $143,785, increase its depreciation expense by $78,763 and increase its amortization of investment tax credit by $43,136 for its proposed attrition adjustment. At the May 1, 1985, hearing Continental revised its revenue adjustment to an increase of $20,705.

Continental has not performed any quantitative analyses to determine the specific factors which should be considered in arriving at an attrition adjustment, other than evaluating its manpower needs. During the hearing, Continental stated that it did not know what its exact investment would be a year from now and did not know the exact make-up of its investment, but stated that the make-up would be different than its present investment.[22] The Commission notes that any change in the make-up of a utility's investment could substantially affect its productivity.

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20 Smail Prefiled Testimony, Schedule 3, Item 2.

21 $513,743 - $67,135 (based on the average intrastate factors for the applicable expense) = $446,608 X .5076 = $226,698.

22 T.E., page 75.

Furthermore, it was identified during cross-examination that cost savings had not been incorporated in its review of attrition.[23] This oversight is of particular relevance in this case due to the implementation of two enhanced computer software packages during the test period. Further, the Commission by allowing adjustments beyond the end of the test period and by using Continental's end of period rate base has taken into consideration the known and measurable future changes in operations which provide Continental adequate coverage for future changes that could potentially erode the level of earnings allowed by this Commission.

The Commission has, therefore, increased Continental's net intrastate operating income available for return by $70,573[24] including a reduction for the proposed investment tax credit. The proposed change to rate base has been reflected in an earlier section of the Order.

Toll Service Revenue and Official Toll

Continental initially proposed a level of $8,064,996 for intrastate toll revenue. Continental chose this level pursuant to the Order in Case No. 8838 issued November 20, 1984.[25] At the May 1, 1985, hearing, Continental amended this figure to $8,123,396

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23 Ibid., pages 77 and 78.

24 $143,785 + ($78,763 X .8176) = $208,182 X .5076 = $105,673 - ($43,136 X .8137) = $70,573.

25 An Investigation of Toll and Access Charge Pricing and Toll Settlement Agreements for Telephone Utilities Pursuant to Changes to be Effective January 1, 1984.

based on the "methodology in Case No. 8838 and the proximity of its implementation to the rate year."[26] Pursuant to a data request dated February 5, 1985, Continental provided a total booked revenue figure of $8,496,271 for the test year. The Commission finds the $8,496,271 to be the reasonable level of revenue for purposes of this case.[27] As Mr. David W. Tuthill, Senior Financial Analyst for Contel Service Corporation, agreed in his testimony at the hearing, the Appendix to the Order in Case No. 8838 dated November 20, 1984, was preliminary in nature and subject to adjustment.[28] The numbers were based upon unaudited annualized data for January 1984 through August 1984. This results in an increase to Continental's net operating income of $218,915.[29]

Continental also proposed an operating expense adjustment of $506,539 for official toll. Of this amount, $91,772 is related to interstate official toll, $376,624 is related to intrastate intraLATA official toll, and $38,143 is related to intrastate interLATA official toll.[30]

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26 T.E., page 99.

27 It should be noted that the actual toll revenue for the calendar year 1984 was $8,747,856.

28 T.E., page 106.

29 $8,496,271 - $8,064,996 = $431,275 X .5076 = $218,915.

30 Response to Staff Data Request dated February 5, 1985, Small, Item 4.

At a late date in this proceeding it became necessary to make certain contacts to verify the analysis of Continental's official toll adjustment and certain facts concerning the adjustment. Thus, during the week of June 10, 1985, discussions concerning the adjustment occurred between the Commission and Ms. Margaret A. Smail, Financial Analyst, and Mr. Tuthill of Continental. Also, discussions concerning intraLATA pool settlements occurred with employees of Bell involved in intraLATA pool administration. These discussions involved the relationship of Continental's official toll adjustments to the Commission's Orders in Case No. 8838. In view of these discussions, should Continental object to the Commission's disposition of its official toll adjustment, then Continental may petition for rehearing on the matter and the Commission will schedule a formal conference.

In prefiled testimony, Ms. Smail observed that prior to January 1, 1984, total official toll expense was absorbed through the separations and settlements process that existed prior to the AT&T divestiture in the form of a lower toll rate of return than would have been otherwise experienced. However, since January 1, 1984, Continental is directly billed for interstate and intrastate interLATA official toll and records interstate and intrastate interLATA official toll on its books as operating expenses.[31]

31 Smail Prefiled Testimony, page 26.

In addition, Ms. Smail supports Continental's intrastate intraLATA official toll adjustment on the grounds that "Beginning June, 1985 the Company will begin reporting intrastate/intraLATA official toll revenue to the intraLATA revenue distribution fund and reflect the associated expense on the books at that time."[32]

In Case No. 8838,[33] the Commission indicated that interstate official toll expense should be assigned to the interstate market and recovered through access charges applicable to the interstate market.[34] Therefore, the Commission will not recognize Continental's proposed interstate official toll expense adjustment in the amount of $91,772.

Also, in Case No. 8838, the Commission indicated that intrastate interLATA official toll expense should be assigned to the interLATA market and recovered through access charges applicable to the interLATA market.[35] Unlike the case with Continental's interstate official toll expense, where, in effect, Continental proposes that the Commission consider the expense but no related revenue, in the case of interLATA official toll expense, the Commission may consider both the expense and related

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32 Ibid.

33 It should be noted that Continental's witness on official toll adjustments, Ms. Smail, and toll revenue requirement, Mr. Tuthill, both indicated that they were not familiar with relevant Orders of the Commission in Case No. 8838, particularly the Commission's Order of February 15, 1985. For example, see T.E., page 58, and T.E., page 114.

34 Order dated February 15, 1985, pages 46-49.

35 Ibid.

revenue. Therefore, the Commission will recognize Continental's proposed intrastate interLATA official toll expense adjustment in the amount of $38,143.

As Ms. Smail indicated in prefiled testimony, interstate and intrastate interLATA official toll is compensated on a "bill and keep" basis. However, intrastate intraLATA official toll is not compensated on a "bill and keep" basis. IntraLATA official toll is compensated through pool settlements, in a way that resembles the prior separations and settlements process. Moreover, although at the time that Continental filed its case, there may have been plans to place intraLATA official toll on a "bill and keep" basis, the Commission takes notice of the fact that intraLATA official toll compensation still occurs through pool settlements and no plan to change the method of settlement has been filed with the Commission by the pool administrator.

In the opinion of the Commission, since intrastate intraLATA official toll compensation occurs through pool settlements, there is no basis for also recovering intraLATA official toll expense through local service rates, a position with which Ms. Smail apparently agrees.[36] Therefore, the Commission will not recognize Continental's proposed intrastate intraLATA official toll expense adjustment in the amount of $376,624. These adjustments to official toll result in an increase in net operating income of $237,758.

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[36] T.E., page 65.

Private Line Revenue

As mentioned by the AG, in its Brief[37] after the hearing in this case, the Commission in Case No. 9160 dated May 2, 1985,[38] granted Bell a 15 percent increase in private line rates and revenues. Continental concurs with Bell's private line tariffs. Absent evidence showing the exact amount of revenue Continental can expect under the settlement process, the Commission is of the opinion that the entire 15 percent increase should be reflected in Continental's pro forma private line toll revenue. This adjustment is in accordance with treatment previously rendered in past cases to this adjustment.

The Commission has determined this revenue to be $384,750;[39] therefore, the 15 percent increase is $50,185. This results in an increase to Continental's pro forma intrastate net operating income available for return of $25,474.

Employee Concession Service

During the test period Continental granted its employees concessions amounting to $30,931,[40] consisting of reduced rates for local telephone service. The Commission is of the opinion that the ratepayer should not be required to pay the cost of employee concession service as no tangible benefits accrue to the

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37 AG's Brief, May 22, 1985, page 5.

38 Petition of South Central Bell Telephone To Change and Increase Certain Rates Charges for Intrastate Telephone Service.

39 Adjusted Private Line Revenue of $334,565 x 1.15 = $384,750.

40 Updated pursuant to May 1, 1985, hearing.

ratepayers. Therefore, the Commission has increased Continental's local service revenues by this amount.

This adjustment is in accordance with Commission decisions on this issue in other recent cases and has the effect of increasing Continental's intrastate net operating income available for return by $15,701.

Depreciation Expense

Continental proposed to increase its combined test period depreciation and amortization expense of $7,295,095 by $499,871 to a pro forma level of $7,794,966 in order to reflect the Remaining Life depreciation rates allowed by the Commission in Case No. 8861[41] and the difference in applying the Equal Life Group rates and Remaining Life rates to the additions made to the Equal Life Group accounts approved during the test period.

This adjustment also included $284,073 for increased amortization as a result of implementing a 3-year write-off of Station Apparatus pursuant to the Commission's preliminary draft Order in Administrative Case No. 269. Since this was a preliminary Order, the Commission will reject Continental's proposal at this time. Continental further revised its adjusted level to include changes to reflect the effects on this expense of the proposed changes to plant in service associated with its CPE erosion adjustment, attrition, mobile telephones and direct sales as discussed in applicable sections of this Order.

41 Notice of Continental Telephone Company of an Adjustment in Its Rates, dated January 4, 1984.

The rejection of the 3-year amortization has the effect of increasing Continental's net operating income by $117,894.[42]

Interest Synchronization

Continental proposed intrastate interest expense for rate-making purposes of $2,479,562. The Commission continues to be of the opinion that its past treatment of JDIC is proper and consistent with IRS regulations and such treatment will continue in this proceeding. In accordance with past practice, the Commission has applied the cost rates applicable to long-term debt to the JDIC allocated to the debt components of the capital structure. Using the capital structure allowed herein, the Commission has imputed an interest expense of $2,716,412 which results in an increase in Continental's intrastate net operating income available for return of $116,625.[43] However, as this issue is currently on review to the Kentucky Supreme Court, the Commission finds it reasonable to continue to adopt the position taken in Case No. 8861. In that proceeding the Commission stated that if a final decision should be adverse to the Commission's position, it would consider a rate adjustment to generate the revenues associated with JDIC. This should eliminate the need for judicial appeal of the matter.

Affiliated Transactions

In its previous Order in Case No. 9011, the Commission concurred with its prior decision in Case No. 8861 in limiting

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42 $284,073 X .8176 X .5076 + $117,894.

43 $2,716,412 - $2,479,562 = $236,850 x .4924 = $116,625.

affiliated charges to the Consumer Price Index growth rate. No additional evidence has been presented in this case to support a change in the Commission's findings as set forth in the previous Orders. Mr. William Oberdorfer, Senior Financial Analyst for Contel Service Corporation, stated that the Ernst and Whinney Study was based on total company operations. Mr. Oberdorfer pointed out at the hearing that it is important to look at the whole operations of the company; however, the Commission is convinced that a study of Kentucky-specific operations would better evaluate the benefits to Kentucky ratepayers. The possibility of Continental's ratepayers providing revenues in excess of those otherwise required to pay for these services is of great concern to the Commission.

In Case No. 9011, the Commission allowed $1,507,955 for affiliated charges based on the compound growth rate of 9.49 percent in the Ernst and Whinney Study and the expense level for the test period in the executive department, revenue accounting and general service and business. The rate was developed for the period of 1978-1982 and would have necessarily changed with time. Since no further evidence has been presented in this case, the Commission has no alternative but to make a similar adjustment at this time. Therefore, the Commission has increased the level allowed in Case No. 9011 by 2.9 percent to recognize the change in the Consumer Price Index from February 1984, the prior test period, to October 1984. This results in an adjusted level of $1,550,178. During the test period, $1,820,176 was included on a combined basis for affiliated charges. The difference of $269,998 would increase Continental's intrastate income by $107,215.[44]

The Ernst and Whinney Study was a step in the right direction, but is still far from the objective of determining the benefit to specific groups of ratepayers, particularly those in Kentucky. In order for Continental to convince the Commission in future cases of the appropriateness of this expense, it will be necessary to show direct benefits to the Kentucky ratepayers.

Summary of Adjusted Net Operating Income

The Commission, based on the foregoing analysis, has determined Continental's appropriate intrastate adjusted test period net operating income available for return to be $6,492,880 as set out below.

	Proposed	Adjustments	Reasonable
Operating Revenues	$ 25,680,132	$1,169,919	$ 26,850,051
Operating Expenses	20,353,102	4,069	20,357,171
Net Operating Income	$ 5,327,030	$1,165,850	$ 6,492,880

EARNINGS

In its application and Brief, Continental contended that its earnings during the test year had been seriously inadequate. However, in response to item 32 of the Commission's December 20, 1984, data request, Continental stated that its actual test period earnings on average equity were 17.02 percent. During the hearing Continental proposed to offer an exhibit showing its alleged

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44 $269,998 x .7823 (average intrastate factor) x .5076 = $107,215.

inadequate past earnings, but subsequently withdrew the exhibit after questions were raised about comparing the data in the proposed exhibits to the information filed in response to data requests. In its Brief, Continental acknowledged the accuracy of the 17.02 percent figure, but then contended that a more accurate number was 11.71 percent return on equity. This figure does not appear in the record and it is not possible from the Brief to ascertain the derivation of this number. In the Brief it is contended that the 17.02 percent is inaccurate because it includes earnings from non-jurisdictional activities. However, non-jurisdictional investment would also be included, and Continental's non-jurisdictional activities are not substantial enough to explain such a deviation. Even after adjusting for investment made during the test year and known and measurable adjustments to revenues and expenses allowed herein, which include wage increases occuring after the end of the test period, Continental would have had earnings on equity of 14.1 percent before any rate increase.[45] Therefore its argument of totally inadequate earnings is without merit.

RATE OF RETURN

Capital Structure

Dr. Charles E. Olson, President of Olson and Company, Inc., and witness for Continental, recommended an actual end-of-test-year capital structure containing 54.53 percent

45 $6,492,880 - $2,716,412 - ($1,149,886 x .093) = $3,669,529 ÷ $26,075,250 = 14.1 percent.

long-term debt, 1.92 percent preferred stock and 43.55 percent common equity.[46] The Commission is of the opinion that this capital structure is reasonable and will be used to determine the composite cost of capital for Continental.

Cost of Debt

Dr. Olson proposed an 8.32 percent cost of long-term debt and a 9.3 percent cost of preferred stock.[47] These are the embedded costs for the test year. The Commission is of the opinion that these embedded costs are reasonable.

Return on Equity

Dr. Olson recommended a 16.25 percent return on equity for Continental.[48] He performed a discounted cash flow ("DCF") analysis for a group of four telephone companies whose operations were similar to Continental's, in his opinion. He checked those results by performing a DCF analysis for Telecom and the seven Bell holding companies and by performing a risk premium analysis. Based on those analyses, Dr. Olson determined that the required return on equity for Continental was 15.1 to 15.6 percent. He then added 50 basis points to that range to adjust for risk differences between Continental and the four comparable telephone companies.[49] Dr. Olson also made an upward adjustment to

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46 Olson Prefiled Testimony, page 9.

47 Ibid., page 31.

48 Ibid., page 30.

49 Ibid., page 26.

Continental's required return to compensate for financing costs and market pressure.[50] Adding Dr. Olson's adjustments to the 15.1 to 15.6 percent range produces his 16.25 to 16.75 recommended return on equity for Continental.

The Commission is of the opinion that Dr. Olson may have overstated the required return on equity for Continental. Dr. Olson used an 8.1 percent average dividend yield in his DCF analysis of the four comparable telephone utilities. The market prices he used were averages for the period from June through November 1984.[51] Market prices for these firms have been rising recently. At the hearing, Dr. Olson calculated a 6.65 percent average dividend yield for the comparable telephone companies, using then current market prices.[52] Dr. Olson used an 8 percent dividend yield in his DCF analysis of Telecom. However, Telecom's dividend yield has also been declining due to a rising market price. At the hearing, Dr. Olson agreed that Telecom's dividend yield was then currently about 7.4 percent.[53] Dividend yields will fluctuate because market prices fluctuate. However, there appears to be a general upward movement in the market prices of Dr. Olson's comparable telephone companies and Telecom.

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50 Ibid., page 28.

51 Ibid., Schedule No. 3.

52 T.E., page 141.

53 Ibid., page 141.

Therefore, the Commission is of the opinion that Dr. Olson's dividend yields are too high.

Dr. Olson used a 7 to 7.5 percent dividend growth rate in his DCF analysis of the four comparable telephone companies.[54] The average projected dividend growth rate for the group is approximately 5.3 percent, according to Value Line.[55] Dr. Olson also used a 7 to 7.5 percent dividend growth rate in his DCF analysis of Telecom.[56] Value Line projected a 5 percent dividend growth rate for Telecom.[57] Dr. Olson also performed a DCF analysis for the seven Bell holding companies. He used a 6 to 6.5 percent growth rate in his DCF calculation.[58] Dr. Olson calculated an earnings retention ratio times the return on equity ("b x r") growth rate of 4.8 percent for the group.[59] Earnings per share for the group are expected to grow at a 5.7 percent rate according to Standard and Poor's Earnings Forecaster.[60] The Commission is of the opinion that Dr. Olson has overstated the dividend growth rate in each of his three DCF calculations.

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54 Olson Prefiled Testimony, page 16.

55 T.E., page 142.

56 Olson Prefiled Testimony, page 19.

57 T.E., page 145.

58 Olson Prefiled Testimony, page 26.

59 Ibid., page 24.

60 Ibid., page 25.

Based on judgment, Dr. Olson added 50 basis points to his recommended return to reflect risk differences between Continental and the four comparable telephone companies.[61] He pointed out that the average common equity ratio for the group was 59.88 percent while Continental's equity ratio was 43.55 percent.[62] However, all four of Dr. Olson's comparable telephone companies stand alone while Continental is a subsidiary. A stand-alone company might require a somewhat higher equity ratio than a subsidiary. Continental's lower equity ratio may not indicate higher overall risk, requiring a 50 basis points premium. Dr. Olson also increased Continental's required return to compensate for financing costs and market pressure. However, since Continental's stock is not publicly traded or issued, there should be no significant financing costs or market pressure. Adding 50 basis points for risk differences and adjusting for financing costs and market pressure will tend to overstate Continental's actual cost of equity.

Finally, Dr. Olson performed a risk premium analysis to check the results of his DCF analyses. At the hearing, Dr. Olson agreed that the risk premium fluctuated over time.[63] Risk premiums vary greatly with changing market conditions. Quantifying an appropriate risk premium to use in calculating a cost of equity is consequently very difficult. The Commission

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61 T.E., page 146.

62 Olson Prefiled Testimony, page 26.

63 T.E., page 146.

continues to have serious reservations regarding the validity and usefulness of the risk premium analysis.

After considering all of the evidence, including current economic conditions, the Commission is of the opinion that a return on equity in the range of 14 to 15 percent is fair, just and reasonable. This range recognizes Continental's subsidiary relationship with Telecom and the level of risk of providing basic telephone service, which may be less for Continental than for other telephone utilities. Continental's service area is primarily rural and has no large concentration of business customers. Therefore, Continental is exposed to relatively less risk. A return on equity in this range will not only allow Continental to attract capital at reasonable costs to insure continued service and provide for necessary expansion to meet future requirements, but also will result in the lowest reasonable cost to the ratepayer. A return on equity of 14.5 percent will allow Continental to attain the above objectives and is the return authorized by the Commission.

Rate of Return Summary

Applying rates of 8.32 percent for long-term debt, 9.3 percent for preferred stock and 14.5 percent for common equity to the capital structure approved herein produces an overall cost of capital of 11.03 percent. The additional revenue granted herein will provide a rate of return on net investment of 10.95 percent. The Commission finds this overall cost of capital to be fair, just and reasonable.

REVENUE REQUIREMENTS

The additional revenue required based on the rate of return found fair herein is computed as follows:

Required Net Operating Income	$ 6,604,138
Adjusted Net Operating Income	6,492,880
Deficiency	$ 111,258
Deficiency Adjusted for Taxes (.5076)	$ 219,184

RATE DESIGN

Continental proposed to allocate its entire additional revenue requirement in this case to local exchange access and foreign exchange services. In addition, Continental proposed to consolidate its existing flat rate schedule, reducing the number of rate groups from 12 to 6.

In this case, the Commission will allocate all additional revenue requirement to local exchange access and foreign exchange services. The revenue impact of Continental's proposed rate group consolidation is minimal and should be allowed, amounting to $96,000 as compared to total test period local exchange access revenue of $11,785,000.

The Commission's ability to allocate additional revenue requirement to other categories of service in this case is limited. First, the record in the case indicates that service charges and operator and directory assistance charges are compensatory at present rate levels. Second, Continental's terminal equipment base is small and substantial increases in these rates would not generate revenues sufficient to significantly change local exchange access and foreign exchange service rates. Third, adjustments in access charges should not be ordered at this time.

CONSTRUCTION

In this case Continental provided information and testimony relative to its proposed Construction Budget. The Commission's concern in Continental's last rate Order was related to major construction programs such as central office equipment ("COE") and large outside plant modernization projects. In particular, the Commission was, and is, concerned as to whether these major projects are economically cost-justified. Additionally, what is the impact when these projects, such as COE, are replaced or changed-out prior to fulfilling economic expectations? Should ratepayers assume these risks for Continental, or should Continental bear some of that risk?

As part of the construction planning process, Continental performs studies designed to show whether a particular project is economical, or "cost-justified". Continental has filed a considerable amount of material with the Commission, particularly since the last rate Order, which addresses these studies. Two of the important inputs into these studies are typically the expected maintenance and labor savings, and additional revenues which will be derived from the offering of "enhanced" services, which will result from the implementation of a given project. These factors are highly dependent upon the expected time during which the particular plant asset will be used and useful.

If a particular project is completed and later changed-out before that time period has elapsed, or if the expected savings/increased revenues do not materialize, it is quite possible that Continental's ratepayers have not benefited, at best, and possibly have been penalized, because of the cost of that project. Continental's studies which have been provided previously to the Commission do not indicate that Continental attempts to quantify whether the economic expectations have actually been met. Since these factors are an important measurement of whether the ratepayers have benefited from a particular project, the Commission has determined that Continental should be required, at least on COE replacement projects, to determine whether or not an actual "payback" has occurred. In effect, Continental must determine whether the existing central office has been cost-justified from the ratepayer's perspective. Obviously, this requirement should only be placed on proposed change-outs of existing electronic and digital central offices and on all newly placed offices on a "going-forward" basis. To place such a requirement on replacement of existing step and crossbar offices would not achieve any worthwhile purpose.

The Commission is aware that Continental will have to develop and implement a plan to perform these payback studies on the most economical basis. Therefore, Continental should be allowed a period of time to develop and submit its proposal for implementing this requirement. Given the fact that this will be limited in scope to central office projects, Continental should submit such a proposal within 90 days of the date of this Order. This information will allow the Commission in the future to make a more informed judgment concering the economy of proposed central office replacement projects.

FINDINGS AND ORDERS

After reviewing the evidence of record and being advised, the Commission is of the opinion and finds that:

1. The rates and charges proposed by Continental should be denied upon application of KRS 278.030.

2. The rates and charges in Appendix A are the fair, just and reasonable rates to be charged by Continental on and after June 17, 1985.

3. Continental should file its revised tariffs sheets with the Commission setting out the rates and charges approved herein within 30 days of the date of this Order.

4. Continental should be required to submit to the Commission, within 90 days of the date of this Order, a proposal or plan by which it will incorporate a study relative to whether the actual payback period has been reached on all exisiting electronic and digital central offices which are scheduled for replacement, and on all newly placed central offices on a "going-forward" basis which are scheduled for replacement in the future.

IT IS THEREFORE ORDERED that the rates and charges proposed by Continental be and they hereby are denied upon application of KRS 278.030.

IT IS FURTHER ORDERED that the rates and charges in Appendix A are the fair, just and reasonable rates to be charged by Continental for service rendered on and after June 17, 1985.

IT IS FURTHER ORDERED that Continental shall submit to the Commission, within 90 days of the date of this Order, a proposal or plan by which it will incorporate a study relative to whether the actual payback period has been reached on all existing electronic and digital central offices which are scheduled for replacement, and on all newly placed central offices on a "going-forward" basis which are scheduled for replacement in the future.

IT IS FURTHER ORDERED that Continental shall file its revised tariff sheets with this Commission setting forth the rates and charges allowed herein within 30 days of the date of this Order.

Done at Frankfort, Kentucky, this 20th day of June, 1985.

PUBLIC SERVICE COMMISSION

Richard D. Heman, Jr.
Chairman

Vice Chairman

Commissioner

ATTEST:

Secretary

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 9230 DATED JUNE 20, 1985

The following rates and charges are prescribed for the customers in the area served by Continental Telephone Company. All other rates and charges not specifically mentioned herein shall remain the same as those in effect under authority of this Commission prior to the effective date of this Order.

GENERAL EXCHANGE TARIFF
LOCAL EXCHANGE SERVICE

II. LOCAL SERVICE RATE GROUPS

Local service rate groups are established as follows, based on the total number of access lines in the local calling area:

Rate Group No.	Access Lines in Local Calling Area
1	0 - 2,300
2	2,301 - 4,300
3	4,301 - 6,900
4	6,901 - 14,000
5	14,001 - 31,000

IV. CLASSIFICATION OF EXCHANGES BY RATE GROUPS

Rate Group No.	Exchanges
1	Mount Olivet, Arling, Milburn Bardwell, Columbus, Evarts
2	Augusta, Brooks, Germantown, Johnsville, Mammoth Cave, Smithland Bee Spring, Brodhead, Brownsville, Irvine, Livingston, Mount Vernon
3	Barbourville, Flatlick, Manchester and Oneida Canneyville, Clarkson, Dover, Fernleaf, Lewisburg, Mays Lick, and Washington
4	Calvert City and Jenkins East Bernstadt and London

Rate Group No.	Exchanges
5	Faubush, Park City, Science Hill, Shopville, and White Lily Eubank, Smiths Grove
Special	Cumberland

VI. MONTHLY ACCESS LINE RATES

	Rate Group					
Access Line	1	2	3	4	5	Special*
Business						
1-Pty.	$ 25.98	$ 27.28	$ 29.02	$ 29.78	$ 31.08	$ 24.68
2-Pty.	NA	NA	NA	NA	NA	21.71
4-Pty.	17.32	18.16	18.86	19.58	20.29	16.45
Business Trunk	71.93	75.04	78.20	81.49	84.66	68.33
Key Line	54.74	57.32	59.78	62.36	64.95	52.00
Semi-Public	43.17	45.04	46.92	48.92	50.86	41.01
Multi-line	38.97	40.91	42.72	44.65	46.59	37.02
Residence						
1-Pty.	15.18	15.95	16.73	17.51	18.35	14.42
2-Pty.	NA	NA	NA	NA	NA	12.68
4-Pty.	11.76	12.34	12.85	13.24	13.83	11.17
Key Line	32.50	34.06	35.54	37.16	38.77	30.87
Multi-line	22.81	23.98	25.07	26.30	27.53	21.66

* Cumberland Exchange